Supreme Court, U.S.
FILED
NOV 23 1992
OFFICE OF THE CLERK

No. 92-678

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1992

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THE BOARD OF ADMINISTRATION OF THE PUBLIC EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF CALIFORNIA, *et al.*, *Petitioners*,

v.

PETE WILSON, Governor of the State of California; GRAY DAVIS, State Controller of the State of California; KATHLEEN BROWN, State Treasurer of the State of California; and THOMAS W. HAYES, Director of the Department of Finance, State of California, *Respondents*.

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**On Petition for a Writ of Certiorari to the Court of Appeal of California Third Appellate District**

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## REPLY BRIEF FOR PETITIONERS

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## REPLY BRIEF FOR PETITIONERS

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The petition in this case raises three legal claims: (1) that the court below committed a fundamental constitutional error in holding that a State could impair its own contracts solely in order to save money; (2) that the State's expropriation of $1.9 billion of pension funds previously dedicated to pay cost-of-living adjustments (COLAs) for pensioners unconstitutionally impaired the State's pension contract with its employees; and (3) that the State's substitution of a politically appointed actuary for the independent PERS Board also was an unconstitu-

tional impairment of contract. As to the first two claims, respondents have simply failed to join issue, as we will demonstrate below. With respect to the third claim, we agree with respondents that it has become moot as a result of a California ballot initiative, passed on November 3, 1992, restoring actuarial authority to the PERS Board.

1. The California Court of Appeal in this case found that the State had changed its pension contract for only one reason—to "sav[e] [the] public employer money." Pet. App. 21a. The court then concluded that this "is not an illicit [constitutional] purpose." *Ibid.* That holding, as we demonstrated in the petition (at p. 12), squarely conflicts with this Court's decision in *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977), and its progeny in the federal courts of appeals. *See also Lynch v. United States*, 292 U.S. 571, 580 (1934) ("Congress [is] without power to reduce expenditures by abrogating contractual obligations of the United States"); *Perry v. United States*, 294 U.S. 330, 353-54 (1935) (same). This principle is so well established that the United States recently "concede[d] that the government may *not* alter contracts simply to save money." *Alpine Ridge Group v. Kemp*, 955 F.2d 1382, 1387 (9th Cir.), *cert. granted*, 61 U.S.L.W. 3367 (Nov. 16, 1992) (No. 92-551) (emphasis added).

Respondents have refused to come to grips with this fundamental constitutional error made by the court below. Like that court, respondents do not even address, much less attempt to distinguish, the discussion of legitimate and illegitimate purposes for contractual impairments in *United States Trust Co.* or other precedents. Instead, they contend, in the words of their argument heading, that "as a factual matter, the new [pension] benefits were comparable to the old benefits." Br. in Opp. 5. This argument, even if it were correct, which it is not (*see* p. 4 *infra*), would still be inadequate. To

pass constitutional muster a State must show not only that a unilateral modification of its own contract was "reasonable," but also that the change was "necessary to serve an important public purpose." *United States Trust Co.*, 431 U.S. at 25, 29. While "comparability" may say something about the reasonableness of a contract impairment, it says nothing about the necessity for such an action. The latter requirement can only be assessed in terms of the State's *purpose* for dishonoring its own contract—and here that purpose (saving governmental money) does not, as a matter of settled Contract Clause law, amount to necessity.[1]

Respondents mistakenly attempt to fashion a new constitutional standard, focused only on comparability, out of the statement in *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 245 (1978), that "[m]inimal alteration of contractual obligations may end the inquiry at its first stage." Br. in Opp. 6. But, leaving aside the pointed use of the word "may" in that sentence, the *Allied Steel* decision only involved State modification of a contract between *private* parties. Indeed, the Court in *Allied Steel* expressly noted that application of the Contract Clause is "more stringent" when the State is a party to the contract. 438 U.S. at 244 n.15. In such a setting, as this

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[1]Ignoring the teachings of this Court's cases, and without citation or analysis, respondents blithely assert that "a detailed inquiry into the necessity of chapter 83 was not required here because the existence of the State's $14 billion dollar budget shortfall, and the State's overriding interest in closing this shortfall, were never seriously contested or challenged in this case." Br. in Opp. 12. This carefully worded statement cannot mask the fact that the *court below* completely ignored the "necessity" portion of the constitutional inquiry. In any event, as noted in text, respondents' suggestion that a State can abrogate its contracts because it faces a budgetary shortfall was squarely rejected in *United States Trust Co.*, where this Court ruled that such a view of "the Contract Clause would provide no protection at all." 431 U.S. at 26. Political convenience, which is what respondents are talking about, is not constitutional necessity.

case illustrates, concerns about the underlying purpose of the impairment are far more salient, because "the State's self-interest is at stake." *United States Trust Co.*, 431 U.S. at 26. *See also Perry*, 294 U.S. at 350-51 ("[t]here is a clear distinction between the power of the Congress to control or interdict the contracts of private parties when they interfere with the exercise of its constitutional authority, and the power of Congress to alter or repudiate the substance of its own engagements").

The emptiness of respondents' one-dimensional constitutional focus on comparability is demonstrated by their insistence that the new benefit provided to petitioners is "comparable" to the one taken away from them. While predictable, such an argument must be viewed with considerable skepticism when it is being pressed by a State that stands to benefit financially by impairing its contract. From a constitutional viewpoint, of course, the critical consideration is that petitioners—whose contract right is being denied here—do *not* think the benefits are comparable. And, quite obviously, they are right in that judgment.

Indeed, given that the State's only reason for impairing its contract with petitioners was to save *itself* money, it is nothing short of remarkable that respondents were successful in persuading the court below to take the opposite view. After all, neither respondents nor the court below have attempted to explain how the State's expropriation of $1.9 billion, previously committed solely to pay the old benefits, could possibly leave petitioners in a "comparable" position when they received new contingent benefits funded without such reserves. Nor have they explained how *prospective* funding for the new benefits remained comparable when it was capped at 1.1 percent of employee assets—after a decade of experience with the old benefits during which funding consistently exceeded 1.5 percent of those assets. These unanswered questions show how utterly toothless respondents' comparability test really is.

Respondents also make a last-ditch effort to obscure the important constitutional question presented by arguing that the contract itself implicitly authorized what the State did here, and therefore was not impaired at all. Thus, respondents passingly suggest that the two-part reasonable-modification standard—requiring that a change in vested pension rights be materially related to the "theory and successful operation of a pension system" and be accompanied by "comparable new advantages" (*Allen v. Board of Admin.*, 665 P.2d 534, 538 (Cal. 1983))—is a part of the pension contract itself. Br. in Opp. 11-12. That contention rests on a serious misreading of the *Allen* case (*see id.* at 9), in which the California Supreme Court expressly held that this two-part test was based on "the contract clause [of the U.S. Constitution]." 665 P.2d at 535; *see also Betts v. Board of Admin.*, 582 P.2d 614, 619 (Cal. 1978) (failure to meet two-part test means pension modification "cannot *constitutionally* be applied") (emphasis added).[2] In short, the California rule that petitioners challenge cannot properly be viewed as an implicit part of the pension contract based on state law. It is, rather, a constitutional rule that merits review because it was unconstitutionally applied here to allow a State to violate its own contract obligation for the purpose of saving itself money.

2. In response to our second argument—that it violated the "exclusive-benefit" provision of the contract for the

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[2] Respondents quote an earlier statement in *Allen* to the effect that "[n]ot every change in a retirement law constitutes an impairment of the obligations of contracts." 665 P.2d at 537, *quoted in* Br. in Opp. 8-9. *See also* Br. in Opp. 5, 11-12. But, as the plain language in the *Allen* opinion makes clear, that statement does not apply when, as here, vested contract rights *are* at stake and the two-part constitutional rule governing the legitimacy of contract *impairments* applies. Indeed, the language from *Allen* that respondents rely on—which was *not* applied in that case—is followed by a cite to *Stork v. California*, 133 Cal. Rptr. 207 (Ct. App. 1976), a case holding that a reallocation of annual benefits over a retiree's lifetime, with no overall monetary loss, was an unconstitutional impairment.

State to expropriate $1.9 billion in PERS funds, which had been earned solely on employee contributions and had already been dedicated to pay employee COLA benefits, for the purpose of paying future employer contributions to the program—respondents misstate our position and then proceed to rebut the position as misstated. According to respondents, "[p]etitioners allege that certiorari review is necessary because the Court of Appeal misunderstood and wrongly applied its own *Valdes* [*v. Cory*, 189 Cal. Rptr. 212 (Ct. App. 1983)] decision in this case." Br. in Opp. 17. But what *we* alleged is something very different: that the State's maneuver here "contravene[d] petitioners' contract right to have PERS trust funds used 'for the exclusive purposes of providing benefits to participants . . . and defraying reasonable expenses of administering the system.'" Pet. 8 (quoting Cal. Const. art. XVI, § 17(a)).

This state constitutional prohibition, when adopted in 1984, was reinforced by an explicit statutory prohibition against the use of trust funds for any purpose other than administrative costs, investments and benefits in former Cal. Gov't Code § 20203.3. Pet. App. 56a. Recognizing this statutory bar to its use of trust funds for its own purposes, the legislature, in Chapter 83, amended section 20203.3 so that it now reads:

> Notwithstanding any other provision of law, no funds in the retirement fund shall be expended for any purpose other than the cost of administration of the system, investments for the benefit of the system, *the reduction of employer contributions*, and the provision of benefits to the members and retired members of the system and their survivors and beneficiaries.

Cal. Gov't Code § 20203.3 (West Supp. 1992) (language added by Chapter 83 emphasized). Of course, the legislature could not similarly amend away the state constitutional provision barring the improper use of trust assets, and so it simply ignored it. It is petitioners' contention that both the prior statutory and the current state con-

stitutional bar to the improper use of trust funds created an explicit contractual right of petitioners forbidding the use of trust assets to benefit the State—a contractual right that was overridden when the State took $1.9 billion previously held in trust to pay COLA benefits, and used the money to pay employer contributions.

Respondents never attempt to explain why these "exclusive purpose" provisions are not a part of the employees' pension contract, or why they were not impaired here. In passing, they include a quote indicating that private plans commonly utilize excess investment earnings for the employer's benefit. Br. in Opp. 3-4. That argument is beside the point. Whatever the usual approach may be in private plans, it has no legal relevance to a public system that expressly forbids the use of trust funds for the employers' benefit. The contract here is what matters.

Respondents' singular focus on *Valdes* is not responsive to these concerns because the "exclusive purposes" amendment to the California Constitution was not even adopted until a year *after* that decision. *Compare* Pet. App. 27a-31a (discussing *Valdes*) *with id.* at 31a-33a (separately discussing petitioners' claim under the subsequent "exclusive purposes" amendment). That state constitutional provision—as both respondents and the court below tacitly concede—does, quite plainly, "implicate contract rights." Br. in Opp. 17; *see* Pet. App. 31a-33a. And those rights, equally plainly, were violated when the State took petitioners' money and used it to benefit itself.

Nor was it reasonable for the Court of Appeal here to conclude that this contract was not violated because the expropriated funds, in a literal sense, are ultimately used to pay benefits. As we showed in the petition (at pp. 21-22), that view amounts to nothing but a play on words and, not surprisingly, respondents have not relied on this argument in their opposition. But, while properly walking away from the court's reasoning, respondents

provide no alternative rationale to show that the employees' "exclusive purpose" contract right has not been violated. That is why, we would suggest, respondents chose to mischaracterize our argument to begin with. This studied effort to avoid the issue presented merely confirms the force of petitioners' claim.[3]

3. Respondents dispute our contention that this case raises issues of general importance because the state courts have taken widely divergent views of public employee pension rights and their relationship to the Contract Clause. *See* Pet. 25-26. *See also* Br. *Amicus Curiae* for 14 Separate Public Employee Retirement Systems (detailing the various state laws and court decisions). Respondents' cursory claim that these inconsistent views of pension rights "present no federal questions" simply confirms the obvious point that the States, understandably, would like to prevent any constitutional review when they abrogate their own contracts—by claiming that, as a matter of *state* law, the contract right never existed in the first place. That is a reason, we submit, for this Court to grant, not deny, review. The time has come to insist on some measure of uniformity in this area so that the Contract Clause, like the other provi-

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[3] Respondents add to the confusion by concluding their argument on this point with the assertion that "[c]ertiorari should be denied for want of *jurisdiction* because the redirection of IDDA-EPDA funds impaired no contract and raises no federal questions." Br. in Opp. 18-19 (emphasis added). The question whether this "redirection" impaired contract rights is, of course, a merits question and thus offers no basis to defeat jurisdiction. And the alternative suggestion that "no federal question" is presented is fully disposed of by *Indiana ex rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938) ("in order that the [Contract Clause] may not become a dead letter, we are bound to decide for ourselves whether a contract was made, what are its terms and conditions, and *whether the State has, by later legislation, impaired its obligation*") (emphasis added).

sions of our Constitution, may serve more than an advisory function in this context.[4]

## CONCLUSION

The petition should be granted, except as to the actuarial-control issue raised at pp. 22-25 thereof, which is now moot.

Respectfully submitted,

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[4] Several counties that have also had their pension obligations lessened as a result of Chapter 83 have filed an *amicus* brief in support of respondents. Brief of the Counties of Santa Cruz, *et al.* Their principal argument is that petitioners' claims are meritless because no "contractual rights were created" with respect to the repealed benefits. *Id.* at 5. But that suggestion simply fights the operative premise of the decision below, which was expressly to "assume" that such rights *are* implicated here. Their remaining point, also made by respondents, is that employee jobs were saved as a result of the State's impairment of its pension obligations. But that argument—always available when a State disavows a contract to save money—does not demonstrate constitutional necessity any more than would an asserted need to preserve unrelated state programs. *See United States Trust Co.*, 431 U.S. at 26 ("[i]f a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all") (footnote omitted).

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Dated: November 24, 1992